ERNST & YOUNG LLP ▪ Internal Correspondence ▪ South Region

April 3, 1995

To: G. Marcus Neas

From: James P. Conley

HEALTHSOUTH Corp.

I enclose a copy of a report prepared by the Center for Financial Research and Analysis on our client HEALTHSOUTH Corp. ***Please do not copy or send the report to the client.***

Please review the comments in this report, investigate them as you deem appropriate, and prepare a written report to me by April 19.

Enclosure

COMPANY CFRA REPORT

HEALTHSOUTH Corp.

March 9, 1995

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HEALTHSOUTH Corp.

Two Perimeter Park South
Birmingham, Alabama 35243
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Primary SIC Code: 8093
Ticker Symbol: HRC
Exchange: NYSE
1994 Fiscal Year-End: 12/31/94
Auditor: Ernst & Young

3/8/95 Close: $39
Prior Month: $37.625 - 40.625
52-Week: $25.25 - 41.25
P/E Ratio: 28
Mkt. Cap.: $1.17 billion

HEALTHSOUTH Corp. ("HEALTHSOUTH"), formerly known as HEALTHSOUTH Rehabilitation Corporation (until January 1995), is the nation's largest provider of rehabilitative healthcare services. The Company has established interdisciplinary programs for the rehabilitation of patients experiencing disability due to a wide variety of physical conditions, such as stroke, head injury, orthopaedic problems, neuromuscular disease, and sports-related injuries. Such services include physical therapy, sports medicine, work hardening, neurorehabilitation, occupational therapy, respiratory therapy, speech-language pathology, and rehabilitation nursing. The Company's medical center facilities also provide general and specialty medical and surgical healthcare services.

HEALTHSOUTH has articulated the objective of being the provider of choice for patients, physicians, and payors for inpatient and outpatient rehabilitative healthcare services throughout the United States. At September 30, 1994, the Company had 344 locations in 31 states, the District of Columbia, and Ontario, Canada, including 106 outpatient rehabilitation centers and 103 associated satellite clinics, 41 inpatient rehabilitation facilities with 41 associated satellite outpatient clinics, five medical centers, and 41 locations providing other patient care services.

FINANCIAL SUMMARY

($ millions)	9 Months 1994	9 Months 1993	% Change	1993	1992	% Change
Sales	739.8	357.0	*107%*	482.3	407.0	*19%*
Operating Income	100.4	50.5	*99%*	70.2	56.6	*24%*
Net Income	40.0	28.0	*43%*	6.7	29.7	*(77%)*
Working Capital	180.1	175.4	*3%*	171.6	170.1	*1%*
L-T Debt	849.7	370.3	*130%*	780.0	299.5	*160%*
Total Equity	347.1	315.4	*10%*	295.0	290.1	*2%*

FINDINGS

- Operational concerns
- Aggressive accounting for acquisitions and for startup and related costs
- Weak control environment

Operational Concerns. Such concerns, as outlined below, relate to the composition of HEALTHSOUTH's recent growth; the trend toward greater reliance on Medicare revenues; a growing debt burden; and the boost provided by a sale-leaseback transaction.

- ***Growth by Acquisition.*** Although HEALTHSOUTH's reported revenue for the first nine months of 1994 more-than-doubled (relative to the corresponding prior-year period), this result derived predominantly from the acquisition of National Medical Enterprises, Inc (NME). ***While overall revenue grew by 107%, same-store sales increased by merely 10%.***

  HEALTHSOUTH's recent mergers and acquisitions, and recently announced planned acquisitions, include the purchase of NME on December 31, 1993, for $385.1 million; a merger with ReLife, Inc. (NASDAQ:RELF), consummated through an exchange of common stock, on December 27, 1993; the planned purchase, anticipated in mid-April 1995, of Surgical Health Corporation through a planned exchange of common and preferred stock; and the planned purchase, also anticipated in mid-April 1995, of the rehabilitation hospital division of NovaCare, Inc. (NYSE:NOV) for $235 million.

- ***Growing Medicare Concentration, Falling Margins.*** HEALTHSOUTH, which derives virtually no profit from either Medicare or Medicaid funded patients, has experienced dramatic growth during the first nine months of 1994 in the proportion of revenues derived from Medicare patients (see Table 1 below)--largely because of the heavy concentration of Medicare revenue acquired from NME (see Table 2 on the following page). As a result, ***the Company's net margin for the first nine months plummeted from 7.8% in 1993 to 5.4% in 1994.***

Table 1: Revenue Breakdown

	1994, 9 Months	1993	1992
Medicare	41%	31%	34%
Medicaid	3%	4%	2%
Other	56%	65%	64%

Table 2: Medicare as a Percentage of Revenue

HEALTHSOUTH, Exclusive of NME-Selected Acquisition	Selected Hospitals Acquired from NME	HEALTHSOUTH, Including Hospitals Acquired from NME
30.6%	49.3%	39.7%

- *Debt Burden.* HEALTHSOUTH experienced an explosion of long-term debt during the final quarter of 1993, primarily as a result of the Company's acquisition strategy. Under the weight of its growing debt load, ***the Company saw its interest expense, as a percentage of operating income, more-than-double (for the nine-month period ended September 30) between 1993 and 1994.*** (See Table 3.)

Table 3: Growth in Reported Long-Term Debt, Interest Expense

	9/30/94	12/31/93	9/30/93
Long-Term Debt, Reported	$850 million	$780 million	$370 million
Interest Expense as % of Operating Income[1]	38.6% (9 months)	18.1% (12 months)	18.5% (9 months)

It deserves noting that HEALTHSOUTH's reported long-term debt load is understated by the present value of rent obligations from operating leases (as outlined in the Notes accompanying HEALTHSOUTH's financial statements). Table 4 adjusts certain long-term debt calculations (using conservative assumptions) to incorporate this effect.[2]

The Table shows long-term debt in comparison to both total and tangible assets. The latter calculation removes the effect of ***goodwill and other intangible assets, which jumped during the first nine months of 1994 by 46% (reaching 19% of total assets)***, in the wake of the NME acquisition.

Table 4: Adjustments to Long-Term Debt Calculations (at 9/30/94), Based on Operating Lease Obligations

	Reported	CFRA-Adjusted
L-T Debt / Equity	2.45	2.93
L-T Debt / Total Assets	0.63	0.76
L-T Debt / Tangible Assets	0.78	0.94

1 Operating income for 1993 is adjusted by excluding the operating expense for the NME acquisition.

2 but not adjusting for the effect of the Company's sale-leaseback transaction in June 1994

- ***Beneficial Effects on Reported Financial Condition from Sale-Leaseback Transaction.*** HEALTHSOUTH received a cash infusion of $49 million in June 1994 from Capstone Capital Corporation, as part of a sale-leaseback (SLB) transaction for certain properties. HEALTHSOUTH not only recorded the debt from this transaction off the books, but also realized an $8 million gain, which will be available in future periods to boost the Company's reported earnings (and thus to offset somewhat the deleterious effect on HEALTHSOUTH's net margin of the NME acquisition).

Aggressive Accounting for Acquisitions and for Startup and Related Costs. As outlined below, we feel that HEALTHSOUTH has adopted an aggressive approach in accounting both for acquisitions and for organization, partnership formation, and startup costs.

- ***Accounting for Acquisitions.*** Immediately after acquiring NME on the last day of 1993, HEALTHSOUTH wrote off 13% of the purchase price (amounting to $49.7 million). We would question the motive of any company that takes a large write-off in the immediate aftermath of an acquisition. Assuming that HEALTHSOUTH paid what it considers a fair price for the acquired assets, then the entire amount of the purchase price should remain on the Company's balance sheet. If it considered certain asset accounts over-valued, then it should have reallocated dollars into other asset accounts--whether tangible or intangible. ***By writing off $49.7 million on the date of the acquisition, however, HEALTHSOUTH gives the appearance of "clearing the decks" of expenses that would otherwise have to be charged in future periods against operating income.*** The Company thus appears to have taken a step to improve its reported profitability in those future periods. We therefore warn that future operating results may have to be interpreted in this light. ✓

- ***Accounting for Startup and Related Costs.*** HEALTHSOUTH capitalizes organization, partnership formation, and startup costs, and subsequently amortizes such costs over three years. The balance of capitalized costs in this account, before amortization, totalled $77.9 million at year-end 1994—an increase of $81.5 million from the prior year. ***We feel that such costs should be expensed as incurred,*** since they appear to constitute ordinary, recurring operating expenses.

Weak Control Environment. In general, we feel that the outside members of a public company's Board of Directors should lack any significant affiliation with either the company, its executive officers, or the other Board members outside of their service as directors and their ownership stake in the Company. We also advocate that the Board should be comprised of individuals with a diverse set of experiences and perspectives. Furthermore, we feel that a public company should avoid engaging in any significant related-party transactions with either its directors or officers, or with any relatives of such directors or officers. As outlined below, HEALTHSOUTH's Board appears lacking with regard to such criteria.

- ***Affiliated Members on the Board and on Audit and Compensation Committee.*** Three of the five outside directors on HEALTHSOUTH's Board (George H. Strong, C. Sage Givens, and John S. Chamberlin) serve as directors of Curaflex Health Services, Inc.—for which HEALTHSOUTH Chairman and CEO Richard M. Scrushy also serves as a director. One of the other outside directors, Charles M. Newhall III, serves with Mr. Scrushy as a director of Integrated Health Services, Inc. Only one outside director, Dr. Phillip C. Watkins, appears to lack any such affiliation with Mr. Scrushy.

Messrs. Strong and Givens serve, along with Dr. Watkins, as members of the Audit and Compensation Committee. We are also troubled that this committee, which combines two of the most critical and sensitive corporate oversight functions (and which public companies usually split into two separate committees), met on only a single occasion in 1993 (the last full year for which the Company reported in this area).

- *Lack of Diversity on the Board.* Three of the five outside directors (Messrs. Strong, Givens, and Newhall) have been described by HEALTHSOUTH as serving for their principal occupation either as a private investor or as the general partner of a venture capital business.

- *Generous CEO Compensation.* Mr. Scrushy's 1993 compensation included $2.72 million in salary and bonus; stock option grants worth an estimated $2.64 million; and a windfall gain, which CFRA estimates as worth more than $3 million, resulting from the downward revision of the exercise price of previously granted stock options. His 1994 compensation amounted to $3.2 million in salary plus bonus. Altogether, Mr. Scrushy held over $30 million worth of exercisable in-the-money options at year-end 1993 and nearly $62 million at year-end 1994.

Incidentally, the Board of Directors reported that it had "determined that [the aforementioned repricing of options] was appropriate in light of the decline in the Company's stock price relating to the generally-depressed state of healthcare stocks in early 1993 and the uncertainties surrounding healthcare policy during 1993."[3] CFRA postulates, however, that the Board is unlikely to reprice such options upward in the event that these two conditions abate.

On a more sober note, we would argue that the willingness of a company to engage in the wholesale repricing of options granted to its CEO and other executive officers in effect allows such officers to "have their cake and eat it too." Options are generally viewed as *at-risk* compensation. If companies compensate for unfavorable stock price movements, the down-side of the at-risk component has been neutralized--while the up-side has been expanded. We consider such an approach a clear transfer of wealth to executive option-holders from other Company shareholders. While transfers of wealth may sometimes be justifiable as a means of providing officers with suitable rewards for past efforts or incentives for future service, we feel that they should be formulated and reported on in a significantly more transparent manner--i.e., through either salary, bonuses, or new stock option grants--the value of any of which would be explicitly reported in the annual Proxy Statement.

It also deserves noting that HEALTHSOUTH had planned last year to implement a new, more generous executive stock option plan--but suffered the indignity of seeing the proposal voted down at a shareholder meeting in December 1994. While we consider it encouraging that stockholders took this bold step in preventing what they considered an unwarranted transfer of investors' future wealth into certain executive officer pockets, we are nevertheless troubled by HEALTHSOUTH's attempt to implement a plan that institutional investors (who reportedly led the charge against the stock option plan) would consider out of bounds.

[3] 1993 Proxy Statement

- *Relationship with Capstone Capital.* Between June 23 and September 26, 1994, the Company engaged in roughly $50 million worth of sale-leaseback transactions with Capstone Capital Corp., a REIT established by Mr. Scrushy for the purpose of investing in ancillary hospital facilities adjacent or physically attached to acute-care hospitals.

- *Additional Related-Party Transactions.* HEALTHSOUTH engaged in several significant related-party transactions during 1993 (the last full year for which the Company reported in this area), including the following:

  - The Company paid $3.9 million for computer equipment to GC Enterprises, a value-added reseller owned by Mr. Scrushy's mother.

  - The Company paid $503,047 to Caretenders Health Corp., a home healthcare services provider for which Mr. Scrushy and HEALTHSOUTH Senior Vice President Michael D. Martin formerly served as directors. At year-end 1993, the Company guaranteed $6 million on a line of credit for Caretenders, in exchange for which Caretenders provided HEALTHSOUTH with warrants to purchase 500,000 shares of Caretenders common stock.

  - The Company paid $284,300 for management services rendered to certain physician practices owned by HEALTHSOUTH to MedPartners, Inc. HEALTHSOUTH director and executive officer Larry R. House (President of HEALTHSOUTH International, Inc. and New Business Ventures) is Chairman and CEO of MedPartners; and Mr. Scrushy is a director of MedPartners (with a 10.5% ownership stake as of March 1994).

- *Loans to Officers.* At year-end 1993, the Company had outstanding loans of $414,000 to Mr. House and $400,000 to Executive Vice President and CFO and director Aaron Beam, Jr.

HEALTHSOUTH Corp.
Schedule of Cash Flows
1994 Fiscal Year-End: 12/31/94

	1994	1993	1992
Inflows ($ thousands)			
Operations	132,050	59,767	39,192
Proceeds from Sale of Marketable Secur.	1,660	20,554	14,041
Proceeds from Sale of Prop., Plant, & Equip.	59,025	0	0
Changes in Other Assets	0	0	1,834
Proceeds from Borrowings	550,084	512,710	169,800
Proceeds from Exercise of Options	13,895	1,736	6,788
Proceeds from Stock Issuance	533	0	19,004
Other	1,499	1,061	1,329
Total Inflows	758,746	595,848	251,988
Outflows ($ thousands)			
Purchase of Prop., Plant, & Equip.	123,575	113,161	88,503
Additions to Intangible Assets	59,307	39,156	25,205
Net Assets Acquired through Acquisitions	85,967	428,307	53,961
Changes in Other Assets	17,526	4,846	0
Investments in Marketable Securities	9,126	6,000	13,000
Principal Payments on Debt & Leases	462,481	17,731	61,313
Loans to Empl. Stock Option Plan	0	0	10,000
Transactions Related to Limited Partners	3,146	4,681	14,329
Total Outflows	761,128	613,882	266,311
Inflows (Percentage of Total)			
Operations	17.40%	10.03%	15.55%
Proceeds from Sale of Marketable Secur.	0.22%	3.45%	5.57%
Proceeds from Sale of Prop., Plant, & Equip.	7.78%	0.00%	0.00%
Changes in Other Assets	0.00%	0.00%	0.73%
Proceeds from Borrowings	72.50%	86.05%	67.38%
Proceeds from Exercise of Options	1.83%	0.29%	2.69%
Proceeds from Stock Issuance	0.07%	0.00%	7.54%
Other	0.20%	0.18%	0.53%
Total Inflows	100.00%	100.00%	100.00%
Outflows (Percentage of Total)			
Purchase of Prop., Plant, & Equip.	16.24%	18.43%	33.23%
Additions to Intangible Assets	7.79%	6.38%	9.46%
Net Assets Acquired through Acquisitions	11.29%	69.77%	20.26%
Changes in Other Assets	2.30%	0.79%	0.00%
Investments in Marketable Securities	1.20%	0.98%	4.88%
Principal Payments on Debt & Leases	60.76%	2.89%	23.02%
Loans to Empl. Stock Option Plan	0.00%	0.00%	3.76%
Transactions Related to Limited Partners	0.41%	0.76%	5.38%
Total Outflows	100.00%	100.00%	100.00%

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